House Tax Policy Committee

Hearing on 2009 House Bill 4487
March 3, 2010

Summary of Testimony by
Jeff DeVree, of Clark Hill PLC,
on behalf of the Michigan Oil and Gas Association

Who We Are

The Michigan Oil and Gas Association represents independent producers and royalty owners.

The independent producers are small businesses, including sole proprietors. Many are family-owned and operated. The "major" oil companies no longer have any exploration or production activities in Michigan, and have not for many years.

The typical royalty owner is an individual landowner or investor, including many former landowners such as retired farmers.

Independent producers are the energy farmers. Like agricultural farmers, they are price takers, not price makers. They have no more influence over the price of oil, or gasoline at the pump, than agricultural farmers have over the price of wheat, or food at the grocery store.

Refiners, distributors, retailers, and other downstream groups in the energy industry have their own trade associations.

Our Position On House Bill 4487

House Bill 4487 would increase the severance tax on marginal oil from 4% to 6.6%.

The Michigan Oil and Gas Association opposes this tax increase now, and urges the Committee to take no further action on it, because —

- Marginal oil is an important part of Michigan's oil supply.
- An increase in the severance tax would reduce Michigan's oil production, and eliminate good-paying jobs in the Michigan oil industry, by forcing marginal wells out of production sooner.
- Michigan should maintain the current severance tax rate for marginal oil production to ensure that this energy resource is not wasted and good-paying jobs are not lost.

Background

The Interstate Oil and Gas Compact Commission, of which Michigan is a member, publishes an annual report on production from marginal wells.[1] The IOGCC report explains,

> Generally, these wells started their productive life producing much greater volumes using natural pressure. Over time, the pressure decreases and production drops. That is not to say that the reservoirs which feed the wells are necessarily depleted. It has been estimated that in many cases marginal wells may be accessing a reservoir which stills holds two-thirds of its potential value.
>
> However, because these resources are not always easily or economically accessible, many of the marginal wells in the United States are at risk of being prematurely abandoned, leaving large quantities of oil or gas behind. *2008 IOGCC Report*, p. 1.

The severance tax rate on oil is 6.6%. The rate on gas is 5%. A marginal rate of 4% applies to oil from wells that do not exceed the applicable production limit as follows —

Average Completion Depth (in feet)	Production Limit (barrels/day)
Any depth	10 or less
2,000 or more, but less than 4,000	20 or less
4,000 or more, but less than 6,000	25 or less
6,000 or more, but less than 8,000	30 or less
8,000 or more	35 or less

These categories are taken from federal energy laws and regulations.

Marginal Oil Is An Important Part Of Michigan's Oil Supply

The 2008 IOGCC Report shows the continuing importance of marginal oil wells to our domestic oil supply. In 2007, marginal wells in the first category (10 barrels/day or less)

[1]Interstate Oil and Gas Compact Commission, *Marginal Wells: Fuel for Economic Growth* [hereinafter, the "*IOGCC Report*"]. The Interstate Oil and Gas Compact Commission is a multi-state government agency that promotes the conservation and efficient recovery of our nation's oil and natural gas resources while protecting health, safety and the environment. The IOGCC consists of the governors of 38 states (30 members, including Michigan, and eight associate states) that produce most of the oil and natural gas in the United States, as well as seven international affiliates. Chartered by Congress in 1935, the organization is the oldest and largest interstate compact in the nation. The Michigan Department of Environmental Quality and the Michigan Public Service Commission assisted in compiling information for the report.

accounted for about **28% of our domestic oil production**. *2008 IOGCC Report*, pp. 5 and 15.[2] At current oil prices, this marginal oil **avoids about $15 billion in oil imports**.

In terms of oil production from marginal wells in the first category (10 barrels/day or less), **Michigan ranks 7th in average daily production per well**. *2008 IOGCC Report*, p. 6. This demonstrates that Michigan oil and gas producers are very good at producing oil from marginal wells. Michigan oil and gas producers should be encouraged to keep these wells in production, rather than discouraged by an increase in the severance tax.

An Increase In The Severance Tax Would Reduce Michigan's Oil Production, And Eliminate Good-Paying Jobs in the Michigan Oil Industry, By Forcing Marginal Wells Out Of Production Sooner

An increase in the severance tax rate on marginal production is a cost increase that would force marginal wells out of production sooner.

Oil and gas become "reserves" when they are deemed economically recoverable. *2008 IOGCC Report,* p. 4. This is a function of price and cost, and domestic reserves are affected by production costs, including severance taxes, as well as market prices.

Marginal wells are, by definition, marginally profitable. Regardless of market prices and production costs, there are always oil wells operating at the margin, *i.e.,* the margin of profitability. Market prices and production costs affect where the line is, between profitable and unprofitable wells, but there is always be a line.

Although marginal wells do not produce as much as "normal" wells, they still need the same kind of technical service out in the field and technical and administrative support back at the office. These are good-paying jobs for skilled workers.

Any increase in cost or decrease in price moves the line, leaving more wells on the unprofitable side. When this happens, the wells are shut down, and eventually plugged and abandoned, and the workers are laid off.

Michigan Should Maintain The Current Severance Tax Rate For Marginal Oil Production To Ensure That This Energy Resource Is Not Wasted And Good-Paying Jobs Are Not Lost

Given the importance of marginal oil to Michigan's oil supply, and the sensitivity of marginal wells to changes in production costs, Michigan should maintain the current severance tax rate for marginal oil production to ensure that this energy resource is not wasted and these good-paying jobs are not lost.

[2] All of the figures in the IOGCC Report are based on marginal wells in the first category (10 barrels/day or less). The Report does not include figures from marginal wells in other categories.

Last year, the IOGCC Report noted:

> Marginal production has a distinct advantage over many other types of energy sources... The resource has already been located and quantified - it already exists. *2007 IOGCC Report*, p. 17.

This year, the report continues:

> [It] goes to the heart of conservation values to do all that is possible to productively recover the scarce oil and natural gas resources marginal wells produce.

When marginal wells are shut down, plugged, and abandoned, the economy loses this oil not only as a source of energy, but also as a source of other economic activity. The 2008 IOGCC Report estimates that **every $1 million directly generated by marginal production results in more than $2 million of activity elsewhere in the economy**. The report further estimates that in 2007 abandonments caused the loss of an estimated 7,215 jobs, more than $315 million in earnings, and $1.5 billion in economic output. *2008 IOGCC Report,* pp. 1 and 21.

For the Michigan Treasury, the loss of marginal oil production would reduce tax revenue and royalty income. The loss of marginal oil production would cause a direct loss of severance tax revenue. In 2007, the State received more than $10 million in severance tax revenue on oil from marginal wells in just the first category (10 barrels/day or less). *2008 IOGCC Report,* Table 6.1, p. 24. The loss of economic output causes an indirect loss of other tax revenue. And, for wells located on State lands, the loss of production would cause a direct loss of royalty income.

For the Michigan economy, the loss of marginal oil production would eliminate good-paying jobs for skilled workers, and maybe limit future opportunities. Attached are a couple of news reports about recent discoveries in the Trenton-Black River and Albion-Scipio formations in Jackson and Calhoun counties. The large number of marginal wells in Michigan has helped preserve an industry workforce with the size and skills necessary to pursue these opportunities.

Attachments (2)

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THE JACKSON CITIZEN PATRIOT

Area experiencing oil boom

Sunday, July 19, 2009

By Ken Wyatt

For the Citizen Patriot

Jackson County's oil boom has been raging quietly since a Traverse City oil company struck liquid gold late last year. Now, with hundreds of oil and gas leases being signed in at least nine townships, oil suddenly is this economically challenged county's ace in the hole.

Napoleon Township Clerk Dan Wymer was serious Tuesday when he told fellow board members, ``It looks like Napoleon Township is on the verge of becoming the oil capital of Michigan."

Whether Wymer's optimism is affirmed by output, the county is hot turf for oil companies.

In November, West Bay Exploration Co. of Traverse City discovered oil and natural gas along Baner Road in Napoleon Township. Its well yields 200 barrels a day of oil, plus natural gas.

West Bay has drilled two other wells in Norvell Township. A fourth well is being drilled next to the producing Baner Road well, but at a different angle, said West Bay Vice President Gary Gottschalk.

Gottschalk added the company plans to drill six to eight more wells -- each at a cost of about $1.5 million.

What would be the economic impact on Jackson County and the state? ``It'll be in the millions of dollars," Gottschalk said.

West Bay's success has created enormous interest.

As of March, county Register of Deeds Mindy Reilly recorded 157 oil and gas filings -- basically, lease agreements -- for 2009.

When Reilly updated those figures, she found the total as of July 14 was 598.

Reilly's scan of 2009 filings shows most are clustered in Napoleon, Norvell, Columbia and Leoni townships. But there also have been filings in Pulaski, Grass Lake, Liberty, Hanover and Springport townships.

Several companies are involved. West Bay is the big player. Another Traverse City company, Savoy Exploration Inc., has been signing leases in the area. Others are focusing on western Jackson County.

One new participant is a smaller company, Eagle Hydrocarbons, with offices in Jackson. It is affiliated with R&B Energy Co., 500 W. Michigan Ave., whose president, William E. Best, formed a partnership with a Mount Pleasant man.

Best said about 40 leases have been signed in the Little Wolf Lake area. Between 500 and 600 acres are involved.

``We've just staked out the first site and hope to be drilling by the end of the year,'' he said. He predicted ``there'll be an economic boom in this part of the state.''

Wymer is one of many Napoleon Township residents approached by the companies for a lease agreement. He and other township officials have fielded complaints from concerned residents, but his sense is that people mostly are supportive.

And while the township stands to derive little direct revenue from the oil boom, Wymer is providing oil companies with lists of local vendors that can provide services they will need -- welding, surveying, etc.

``I think most township people take a positive rather than a negative view,'' he said.

In part, he added, that is due to the fact that after West Bay began drilling on Baner Road, it put up berms and trees to minimize impact.

Still, enough concerns were raised that the township put a number of questions to the state Department of Natural Resources. A DNR response, signed by Thomas Godbold, supervisor of the DNR's field operations section, is posted on the township's Web site, www.napoleontownship.us.

The letter addresses seven questions, ranging from whether diesel fuel is used in the drilling process (no) to whether rubber pools are used to catch spilled fluids (yes).

West Bay's Gottschalk emphasized that all operations are regulated by the state Department of Environmental Quality. Moreover, he said the entire community will benefit from the work income, royalty payments made to landowners and a 6 percent state tax on oil and gas production.

One local government already has benefited from the oil boom. The city of Jackson owns 485 acres of land along Big Wolf, Olcott and Little Olcott lakes. Jackson signed a three-year exploration lease with West Bay this year. It has received a check for $72,833.50.

If a successful well is placed on the leased land, it could mean a $20,000 check each month for the city.

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Weekly Update Edition

Current Jackson County activity represents significant step-out from previous production

West Bay Exploration, group of industry partners continue successful Trenton-Black River exploration, development work in Calhoun, Jackson counties

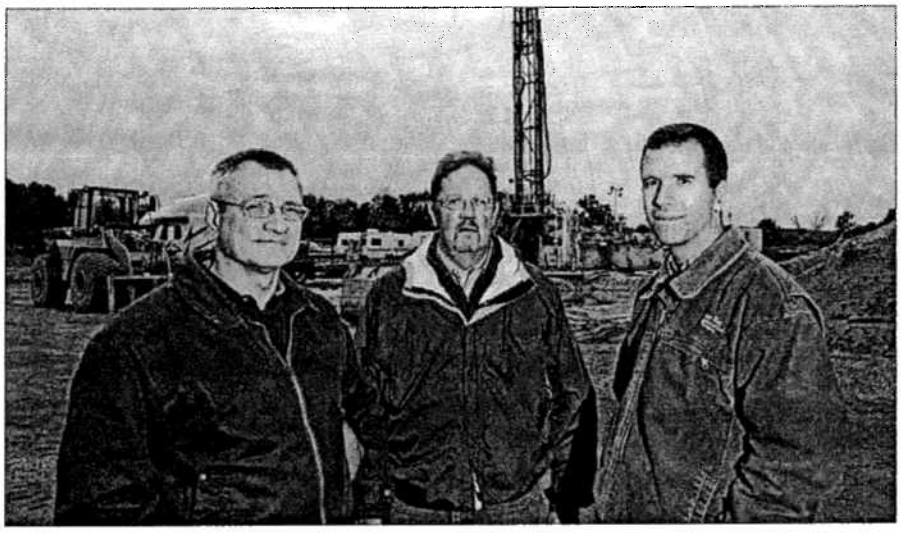
by Scott Bellinger
MOGN Managing Editor

NAPOLEON, Mich. — Traverse City, Mich.-based West Bay Exploration Co. and its industry partners are continuing to build upon the success of an Ordovician Trenton-Black River exploration and development program in proximity to historic Albion-Scipio Trend production in Calhoun County by developing a new play more than 30 miles to the east-southeast in Jackson County's Napoleon and Norvell townships.

West Bay's core group of partners includes Rockford, Mich.-based Trendwell Energy Corp., Polaris Energy, Inc. of Jackson, Mich., and Jordan Development, Co., LLC, Innova Exploration, Inc., Rock Oil Co., LLC, and Energy Quest, Inc., all headquartered in Traverse City, Mich.

Together, the companies have been exploring for Trenton oil production "for a long time," West Bay southern Michigan operations manager Tim Baker noted recently, drilling numerous dry holes before the breakout success of the West Bay-operated Foote 1-12 (SL: NE SW NE, Sec 12-T2S-R5W, Marengo Twp., Calhoun Co.) in mid-2006.

That well is generally credited with reviving industry hope for new Trenton-Black River oil finds in areas of established production from the now half-century old Albion-Pulaski-Scipio Trend, which extends from northeastern Calhoun County through the southwestern corner of Jackson County and into the heart of north central Hillsdale County. More than 700 producing wells drilled in that long, narrow reservoir have made in excess of 120 million barrels oil.



MICHIGAN OIL & GAS NEWS/Scott Bellinger

POLARIS ENERGY's John Fowler (left) and Steve Schaefer (center), and West Bay's Matt Johnston have each made significant contributions to the revival of Trenton-Black River oil production in Calhoun County and a new play in Jackson County. They're shown on the location of West Bay's Warolin 1-30, drilled in Jackson County's Napoleon Township last month.

West Bay's Baker, the company's geophysicist Matt Johnston, and Polaris Energy principals, geologist John Fowler and geophysicist Steve Schaefer, shared some insights into both the science and teamwork behind the play while gathered on location last month during drilling of the Warolin 1-30 (SL: SW NW NE, Sec 30-T3S-R2E, Napoleon Twp., Jackson Co.), the fifth and most recent development test drilled by the group following up on the November 2008 Lantis et al 1-29 (SL: SE NE SE, Sec 30-T3S-R2E, Napoleon Twp., Jackson Co.) oil discovery.

Opening a reservoir preliminarily classified by the Michigan Department of Environmental Quality's Office of

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What's inside...

West Bay, partners continue successful Calhoun, Jackson work —— *(continued from page 1)*

Geological Survey as Napoleon 3 South, the Lantis et al 1-29 discovery was completed for initial production rates of 200 barrels oil, 100 Mcf gas and 3 barrels water daily, and is as significant for its remoteness from existing production as the Foote 1-12 well was for its proximity to previous producing wells.

The West Bay group has drilled a total of 27 confirmed oil producers to date — with typical initial production rates in the 150 barrel per day to 200 barrel per day range — in Calhoun County's Marengo (T2S-R5W), Lee (T1S-R5W), Sheridan (T2S-R4W), and Albion (T3S-R4W) townships, with many of them relatively close to the main body of Albion-Scipio's famed "Golden Gulch."

The Lantis et al 1-29 and the more recently drilled Lantis et al 1-30, Hauser 1-32, Jennings 1-32 HD1, Richardson et al 1-30, and Warolin 1-30, however, are all more than 17 miles east-northeast of the nearest significant Trenton or Black River production, found in the Stoney Point Field, opened in the early 1980s, and are approximately 32 miles from the more recent Calhoun County activity. Fowler characterized the current play as a "major step-out" from previous production.

Just over four miles to the southeast of the Lantis et al 1-29 discovery, the West Bay group this year also successfully completed two wells in Section 16 of Jackson County's Norvell Township (T4S-R2E), the Hilden-Rovsek et al 1-16 and Hilden-Rovsek et al 2-16. It's not known yet if the two reservoirs are connected, Baker said.

Initial production rates for the Jackson wells completed to date have been similar to the successful Calhoun wells.

The representatives of West Bay and its partners made it clear that certain aspects of their exploration work remains

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Rig Locations

(Rigs capable of and/or drilling deep tests in bold type, rigs drilling planned horizontal wells in italic)

ADVANCED ENERGY SERVICES
- Rig 2 — dr SE 12-5S-4E, Clinton, Lenawee (Schmude Oil Inc.)
- Rig 4 — sd
- Rig 8 — sd
- Rig 10 — to mi SW 14-30N-7W, Kearney, Antrim (Atlas Gas & Oil Co.)
- Rig 12 — sd
- Rig 27 — sd

ARROW DRILLING
- Rig 1001 — ru NW 33-19N-6W, Redding, Clare (Presidium Energy LC)
- Rig 1002 — sd
- Rig 1003 — sd

BIGARD & HUGGARD DRILLING
- Rig 1 — dr NW 20-28N-5W, Blue Lake, Kalkaska (Merit Energy Co.)
- Rig 2 — dr NE 34-1S-5W, Lee, Calhoun (West Bay Expl.)
- Rig 3 — sd
- Rig 4 — sd

BRANSEN DRILLING
- Rig 1 — sd
- Rig 4 — sd
- Rig 6 — sd

CONSOLIDATED DRILLING
- **Rig 1 — sd**
- Rig 2 — dr NE 36-6S-2W, Adams, Hillsdale (Continental Resources, Inc.)

POLLISTER DRILLING
- **Rig 2** — dr SE 3-24N-7W, Pioneer, Missaukee (Petoskey Exploration, LLC)

RAMM DRILLING
- Rig 1 — sd

West Bay, partners continue successful Calhoun, Jackson work

(continued from page 21)

proprietary, specifically their methods of interpreting the 2D and 3D seismic data acquired and processed in their prospect generation work.

Johnston may have offered a glimpse into some of his thought processes, however, when less than four months before the drilling of the Foote 1-12 well, he presented a paper entitled "Shallow Seismic Raypath Anomalies and Effects on Niagaran and Trenton Seismic Reflection Character" at the March 23, 2006 Petroleum Technology Transfer Council / Northern Michigan Section, Society of Petroleum Engineers Michigan Field Experiences workshop in Mt. Pleasant, Mich.

In general, the exploration team's work begins with 2D seismic evaluation — typically starting with existing data and often adding new data — before any 3D data is acquired. West Bay's in-house geophysical crew, headed by Jim Bowser, handles all acquisition of new 2D and 3D data. "The work that they do pays great dividends," Schaefer commented.

Collaboration is a theme that seems to run throughout the group's work of exploring for Trenton-Black River oil. "Steve (Schaefer) and I bounce ideas off of each other all the time," Johnston said, adding that "Steve and John's (Fowler) knowledge of the Trenton play has been crucial." Baker also recognized the participation of West Bay geologist Murray Matson, Innova Exploration president and geologist Ron Budros, and Polaris Energy geologist Bill Van Sickel. "Our work together has been a hell of a lot of fun," Fowler said.

Fowler stressed that while seismic may be the most critical tool in the group's toolbox; no stone is left unturned in evaluating the potential of either a development prospect or a rank wildcat area. "We've made use of gravity and magnetics surveys, and subsurface mapping," Fowler said, "about the only thing we haven't used is geochem, and that may be viable too, as oil seeps were reported in the Albion area in the 1840s."

***GATHERED** for a group photo at the Napoleon discovery well, the Lantis et al 1-29, in November 2008 were (from left to right): John Fowler, Bill Van Sickel, Matt Johnston, Rick Slater, Allen Bright, Tim Baker, drilling consultant Bertie Barnett Jr., Ron Budros, and Steve Schaefer.*

Photo courtesy of Innova Exploration

Having an open-minded approach to exploring for Trenton-Black River oil in southern Michigan is not a new idea. The Albion-Scipio discovery well's location is said to have been chosen on the basis of a medium's vision, with no solid geological evidence to support it at the time.

When all of the preliminary evaluation, land, and permitting work are done, Baker and his team make use of a growing knowledge base in terms of the best drilling and completion methods to employ.

"One of the unique things about our partnership is that we can make changes on the fly on how to drill and complete a well," Baker said. "We look for good fluorescence and gas shows," he said, adding that "we think we can see both the gas/oil and oil/water contacts when drilling."

Completion methods have varied from well to well, Baker said. "We tend to get a better completion by completing in the open hole when we're not concerned about the oil/water contact. We have a pretty good handle on the oil column in development situations. We'll typically set casing 20 feet beyond the gas oil/contact, then drill out 30 to 40 feet with a power swivel. If we're drilling a wildcat, open hole completions are out of the question."

When asked how large the current development in Jackson County might ultimately become, Baker said "we're hoping to end up with something like Stoney Point."

"We really do have a great group of people working with us," Baker said. In addition to the geologists and geophysicists that choose the drilling locations, Baker also acknowledged the important roles played by independent consultants such as operations consultant Rick Slater, mudlogger Allen Bright of Basin Logging, Inc., drilling contractors Advanced Energy Services and Bigard & Huggard Drilling, and well servicing contractor McConnell & Scully.